

Feature Article

Accounting: Dealing with the Implications of Accounting Change

The accelerated rate of accounting change is affecting many areas of the organization outside of accounting, and financial executives need to ensure that all these areas — that go beyond the technical requirements — are included in the accounting project team.

By Jerry Arnold, Brian Blisard and Joseph Duggan

Financial executives have always needed to be aware of potential accounting changes. Now, the accelerated scope and pace of proposed changes toward convergence of accounting standards globally has increased the importance of understanding not only the technical details, but also a broad spectrum of implementation requirements and business and technology implications of what could be an unprecedented amount of accounting change.

Today's dynamic regulatory environment, coupled with a sharper focus on accounting, will result in an increasing amount of change and demand for accompanying guidance in the areas of accounting, reporting and auditing.

For example, despite the fact that the recently published final SEC staff report on the International Financial Reporting Standards (IFRS) roadmap does not contain any recommendations for incorporation of IFRS for U.S. registrants and the timing of the U.S. Securities and Exchange Commission (SEC) action is unclear, the Financial Accounting Standards Board (FASB) is continuing to move forward with accounting convergence. This delay in U.S. adoption of IFRS for domestic SEC registrants does not mean that the rate or pace of accounting change will subside.

In fact, it is likely that the pace of accounting change will accelerate over the next few years as FASB and the International Accounting Standards Board (IASB) jointly finalize many of the convergence standards they have been working on. For example, FASB and IASB expect to finalize the new revenue recognition standard in the next six months, as well as continue to work together on several other standards. These include leasing, financial instruments and insurance contracts — all of which could have a significant impact on current accounting and reporting requirements under U.S. generally accepted accounting principles (U.S. GAAP).

In addition to accounting convergence, some companies may need to revise their business

models to adapt to changes in technology and the accounting requirements. As a result, a variety of constituents, including investors, regulators, customers and suppliers, may also be impacted by changes in company business models.

Beyond Accounting Change

Accounting change often requires adjustments to systems, processes, internal controls, business practices and contractual arrangements and an effective financial executive will want to take all of these factors into consideration when analyzing the effects of an accounting change on his or her organization. Leading financial executives should develop and maintain effective management processes to analyze and implement new standards and address the related issues such changes will require.

As illustrated below, there are a number of important matters outside of analyzing the technical accounting issues that financial executives should consider related to a significant accounting change.

- Ensure That the Company has Good Radar.

It is important that financial executives are kept up to speed with major accounting changes that are being contemplated and consider how proposed changes could affect their reported financial results and the manner in which they conduct or contract business.

Executives should have a process for receiving regular updates on the status of proposed accounting changes and other changes that may be on the horizon. Proposed changes that could have a significant effect on the company and have a high probability of being adopted would merit a more detailed analysis of potential implications to address the accounting change as well as the information systems, business practices and processes that will be impacted by the change.

There are many ways for financial executives to monitor accounting developments. Many professional organizations offer webcasts and relevant publications on current standard-setting and regulatory activities. In addition, all the major accounting firms offer thought leadership pieces and training sessions.

- Establish a Consistent Evaluation Process.

For many executives, the challenge is not obtaining the information, but rather having a repeatable process for determining which pending changes could have the greatest impact on their organization. Leading-edge companies regularly analyze potential accounting and reporting changes to be positioned to take appropriate actions when the accounting change needs to be implemented.

Normally, these processes include analyzing the significant proposed changes and developing a

plan that will ensure they are in a position to adopt accounting and regulatory changes when required. This process should include the establishment of a cross-functional team with representatives from the business, legal, information technology, tax and treasury and financial reporting functions.

Establishing a robust process with a cross-functional team is important to ensure that the full impact of an accounting change is considered and that adoption is carried out efficiently and effectively and, if possible, is coordinated with other finance or IT transformation projects underway or being contemplated.

Such a process will also ensure that management has a handle on the accounting changes being considered, they have communicated with the board of directors and the audit committee and, in cases where the change is potentially significant to the company, change management actions have been taken to ensure disruptions from the change will be kept to a minimum.

Companies should also consider participating in the standard-setting process by writing comment letters or participating in the numerous outreach forums, including the roundtables FASB conducts to obtain constituent feedback. In finalizing new standards, FASB has consistently demonstrated its commitment to considering the concerns of the preparer community, as well as those of users.

Factors That Need to be Addressed

There are numerous factors to consider as the company begins to analyze the impact of an accounting change, including the effects on IT; processes, internal controls and data requirements; budgeting, planning and performance monitoring; and contractual arrangements.

- Impact on Information Technology

For sure, IT plays a critical role in enabling companies to determine financial results accurately and report them on a timely basis. Typically, companies have well-thought-out plans regarding the implementation or upgrading of IT systems, and the planning cycle usually starts 18 to 36 months in advance.

As new accounting changes are analyzed, it is important to understand how these changes may affect system requirements and that they are properly considered by the company's finance and IT departments.

For example, the new revenue recognition standard could have a dramatic impact on how some software companies account for revenue. As a result of these potential changes, different information will have to be captured and disclosed, and new estimates and related methodologies will need to be developed around variables such as estimated selling price of software licenses.

In addition, the accounting systems at many companies may not have the functionality necessary to allocate revenue to performance obligations on a relative estimated selling price basis as proposed under the new standard and, therefore, that necessary functionality would need to be added to existing systems or new modules in the future.

These and other required changes could result in significant revisions to IT systems that may or may not be consistent with current plans or projects. Early identification of such matters is important to ensure unnecessary costs are not incurred as a project develops to adopt it for a new accounting requirement.

- New Processes, Internal Controls and Data Requirements

One question that is critical to a smooth transition to any new standard is: Does the accounting change require the company to obtain or develop new data to implement the standard?

The answer will drive companies' consideration of whether and if so how they will obtain the historical data and how they can establish a well-defined, repeatable process for collecting such data going forward.

Here are some examples:

Lease Standards. The proposed new lease standard would require more information regarding the contractual terms of a lease to be disclosed than does the current standard. In addition, once adopted, the company will need a process for obtaining additional lease data. Companies would also need processes to identify a reassessment event on existing leases — something that does not exist under current requirements.

Conflict Minerals Disclosure Requirements. The recently announced conflict mineral disclosure requirements call for SEC registrants to report on the supply chain of certain minerals used in the manufacturing process and whether the minerals originated from the Democratic Republic of the Congo or an adjoining country. To provide the required information, the company will probably need to design new processes and controls to ensure that it can obtain and provide assertions in support of the information.

Revenue Recognition Standard. The new revenue recognition standard would require many companies to begin to collect and analyze additional data regarding selling prices to enable management to estimate standalone selling prices of all the performance obligations included within each arrangement. It also would require significantly more disclosures than is required currently by U.S. GAAP.

The establishment of new processes will also require a detailed analysis of the internal controls that need to be implemented to ensure the process is working correctly.

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Impact on Budgeting, Planning and Performance Monitoring

Questions that will need to be answered include: How will the new standards affect management reporting? Will the new standards require costs to be classified differently or revenue to be recognized in a different manner? If so, are compensation plans such as commissions, bonuses and share-based payment arrangements likely to be impacted?

For example, the new revenue recognition standard may significantly affect the reported results of companies within the software and other industries. The timing of revenue recognition is likely to be accelerated for those companies that have deferred revenue under existing U.S. GAAP due to a lack of vendor-specific objective evidence (VSOE) on undelivered elements. This change can also impact other aspects of the financial statements, including the timing of commission and income tax payments, as well as the level of reported deferred taxes and deferred contract acquisition costs.

Not only will management need to assess the changes to its reporting process going forward, but many new standards require a retrospective application. For example, the new revenue recognition standard currently proposes retrospective application to all historical periods, which would require management to recast financial statements as if the new revenue recognition standard had always been applied.

In addition to the impact on historical revenue, other financial statement line items may be affected, including the recognition of direct costs of contracts (i.e. commission and royalty expenses), reported segment results and income tax expense.

Impact on Other contractual Arrangements

Does the change potentially impact the company's contractual relationships? For example, a new standard could result in potential changes to equity or other balance sheet accounts that might also produce debt compliance issues or affect ratios that are important to investors and analysts.

The new standard could impact contractual terms within revenue arrangements such as payment terms, purchase options, future product discounts, rights of return and other factors and could cause changes in the future, due to the impact those clauses may have on the timing or amount of revenue recognized in future periods under the new standard.

What are Leading-edge Companies Doing To Address Accounting Change?

Rich Beckert, chief financial officer, of CA Technologies, notes: “It is important to establish a project team that is responsible to senior management for performing a complete analysis of the change on the business, systems, people and the processes.

“At CA, the revenue recognition standard will have a significant impact on our business and systems. CA has established a cross-functional project team led by a senior finance executive who is responsible to ensure that the team has addressed not only the accounting and reporting issues, but also fully analyzed impacts on our internal controls, IT systems, business practices, contractual terms and commission plans.

“It is really not just about accounting. The key is to get ahead of the process and not address implementation late in the game so that reporting requirements are considered and that the changes also make sense from a business and IT perspective.”

In summary, in the current and ever-evolving accounting and regulatory environment, it is increasingly important for executives to ensure that their companies have appropriate processes and controls in place to identify, manage and implement accounting change efficiently and effectively.

Executives should take this opportunity to re-evaluate existing processes and controls and ensure that cross-function teams are involved to minimize the impact accounting change will have on their organizations in the future.

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Read more: http://www.financialexecutives.org/KenticoCMS/Financial-Executive-Magazine/2012_11/Dealing-with-the-Implications-of-Accounting-Change.aspx#ixzz2Hd7cEn00